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In the Supreme Court of the United States

OCTOBER TERM, 1951

No. 383

DOUGLAS HOTEL COMPANY, A CORPORATION,
PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Court of Appeals for the Eighth Circuit (R. 123–139) is reported at 190 F. 2d 766. The findings of fact and opinion of the Tax Court (R. 84–96) are reported at 14 T. C. 1136.

JURISDICTION

The judgment of the Court of Appeals (R. 139–140) was entered July 25, 1951. The petition for a writ of certiorari was filed October 15, 1951. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

QUESTIONS PRESENTED

1. Whether the Court of Appeals erred in affirming the holding of the Tax Court, that the land acquired by the Douglas Hotel Company in 1913 should be included in its equity invested capital at a basis not in excess of $125,000.

2. Whether the Court of Appeals erred in affirming the holding of the Tax Court that the equity invested capital of the Douglas Hotel Company under Section 718 of the Internal Revenue Code, for the years here involved, for purposes of the excess profits tax, should be reduced by the sum of $448,438.67, representing the amount of accumulated depreciation reserves which previously had been distributed to its sole stockholder.

STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of the Internal Revenue Code and Treasury Regulations promulgated thereunder are printed in the Appendix, *infra,* pp. 12–16.

STATEMENT

This proceeding involves deficiencies in federal excess profits tax asserted against the Douglas Hotel Company, a Nebraska corporation, with its principal place of business at Omaha, Nebraska (herein sometimes referred to as the taxpayer), for the taxable years 1942 and 1943 (R. 14–19; 36–40; 84–85), pursuant to the pro-

visions of Subchapter E, Chapter 2, of the Internal Revenue Code, as amended.[1]

The Tax Court found the following facts (R. 85–90): The taxpayer was organized in 1913 by a group of Omaha businessmen for the purpose of promoting and building a first-class hotel in that city. A prominent businessman and real estate owner in Omaha, Arthur D. Brandeis, offered to donate the building site for a hotel in the heart of the business district of Omaha, provided other citizens would subscribe for sufficient stock to put the plan in operation. Committees were formed and much of the promotional work was done before 1913. The taxpayer was incorporated January 2, 1913. Brandeis conveyed the building site to the taxpayer by deed dated January 6, 1913 and delivered and recorded March 11, 1913. (R. 85–86, 88.) It consisted of two lots described as lots 7 and 8, block 109, located on the northwest corner of Eighteenth and Douglas Streets. The Omaha newspapers gave considerable prominence to the venture as a civic enterprise and commented upon Brandeis' public-spirited donation of the land for the hotel building. (R. 85–86.)

[1] These provisions were repealed as to years subsequent to 1945 by Section 122 of the Revenue Act of 1945, c. 453, 59 Stat. 556. Substantially similar provisions were enacted by the Excess Profits Tax Act of 1950, enacted Jan. 3, 1951 and effective with respect to taxable years ending after June 30, 1950, 64 Stat. 1137, 26 U. S. C., Supp. IV, 430 *et seq.*

The taxpayer was capitalized at $1,000,000, divided into 10,000 shares of a par value of $100 each. There were 5,000 shares of common and 5,000 shares of 6 per cent cumulative preferred stock which had equal voting rights with the common (R. 86). Article IV of the articles of incorporation, covering the above authorized capitalization, further provided, among other things (R. 87):

> Two Hundred Thousand Dollars of the common stock shall be issued to represent the value of the hotel site donated to the corporation, and it shall be distributed and donated with the Four Hundred Thousand Dollars of the preferred stock first subscribed, one share of common stock being given with two shares of preferred stock. The remaining Three Hundred Thousand Dollars of the common stock, or any part thereof, shall be issued at such times and under such terms and conditions as the board of directors may prescribe.

The first meeting of the taxpayer's stockholders was held January 2, 1913. Prior to that date $300,000 of its preferred stock had been subscribed and under its articles of incorporation the taxpayer was then qualified to let the contract for construction of the hotel (R. 87). A contract was let by the taxpayer during January, 1913, for construction of the hotel building (R. 88).

In April, 1913, Brandeis deeded to the taxpayer on the same basis as lots 7 and 8 an adjoining 22-

foot strip of land, a part of lot 6, block 109. The taxpayer assumed an outstanding mortgage on that property in the amount of $15,000, plus $1,386.08 of outstanding special improvement taxes thereon, all of which it later paid. The taxpayer issued $46,275 of common stock against this additional tract on the same basis as the $200,000 of common shares which it had issued in 1913 during its formative period. This consisted altogether of $494,550 par value of preferred, which was issued for cash, and $246,275 par value of common issued therewith. In its income tax return for 1916 the taxpayer reported paid-up preferred stock of $494,150 and no paid-up common stock. (R. 88–89.)

On the basis of the above and other facts shown by the record, the Tax Court found as a fact that the taxpayer did not acquire the above-described real estate from Brandeis in exchange for shares of its common stock, but acquired it as a donation (R. 88).

Lots 7 and 8, as well as lots 5 and 6, of block 109 had been purchased by Brandeis in November, 1912, for a total consideration of $160,000. In acquiring the property Brandeis represented to the sellers that it was to be used as a site for a new first-class hotel and that he was making a gift of the land for that purpose. (R. 88.)[1a]

[1a] In the absence of evidence to the contrary, the Tax Court assumed that all four lots were approximately equal in value (R. 92).

The new hotel, named Hotel Fontenelle, was completed and opened for business February 27, 1915. The cost of constructing the hotel building was $928,636.38. The land conveyed to it by Brandeis was carried on its books at all times at a total figure of $262,661.08. That amount consists of $246,275 against which the common stock was issued, plus the $15,000 mortgage assumed on the acquisition of a part of lot 5, and plus $1,386.08 of special improvement taxes thereon paid by the taxpayer. (R. 88–89.) For the taxable years here involved the taxpayer included in its equity invested capital, for excess profits tax purposes, the above $262,661.08. In determining the deficiencies involved the Commissioner reduced the taxpayer's land account to $141,386.08 by treating the land acquired from Brandeis in 1913 as having a value of $125,000 at the date of acquisition (R. 16–17).

Voluminous evidence relating to the value of this land at date of acquisition, most of which is not included in the printed record, was introduced before the Tax Court by both parties. On the basis of this evidence the Tax Court found as a fact that the fair market value of this property at the time of acquisition by the taxpayer was not in excess of $125,000 (R. 88).

The Fontenelle Hotel has been operated continuously by a lessee since March 1, 1915 (R. 88). All of its outstanding stock was purchased by Rome Miller, now deceased, in December,

1923, for $1,100,000. After his acquisition of the taxpayer's stock Miller withdrew each year all of the taxpayer's income after payment of the mortgage principal, interest, and current expenses, and also withdrew the idle depreciation reserves. These withdrawals included large amounts in addition to the regularly declared dividends (R. 89). So far as the record shows the withdrawals by Miller from depreciation reserves of the taxpayer amounted to $448,438.67. In its excess profits tax return for 1942 the taxpayer voluntarily reduced its invested capital by this amount, but claimed before the Tax Court that this was error and that the item should be restored (R. 93). The Commissioner made the reduction in computing the deficiency for 1943 (R. 40–41, 92–93). The Tax Court held that these withdrawals from depreciation reserves were not distributions from earnings and profits accumulated after February 28, 1913, and that the taxpayer's equity invested capital was properly reduced accordingly in determining its excess profits tax liability (R. 93–95).

The Court of Appeals affirmed the decision of the Tax Court on each of these issues (R. 123–139).

ARGUMENT

The issues presented by the petition for a writ of certiorari are factual ones, which were rightly decided and present no ground for review by this Court.

1. Taxpayer seeks a reversal of the Tax Court's finding (R. 88), in connection with determining its invested capital, that the value of the land acquired by it in the early part of 1913 did not exceed $125,000. In view of the purchase price paid for that land, together with other land not conveyed to taxpayer, a few months earlier, that holding was clearly supported by substantial evidence, as the court below held (R. 131–133).

The Tax Court's further finding that the land was acquired by gift is also clearly supported by evidence. In any event, however, as pointed out by the Court of Appeals, it is wholly immaterial whether the land was acquired through a donation[2] or in exchange for stock (R. 129–131). In either event, the paid-in capital is dependent upon the fair market value of the land at the time it was acquired by the taxpayer.[3] If acquired as a gift, it is includible in invested capital at its fair market value at the time of its acquisition. See Sections 718 (a) (1) (2) and 113 (a) (4) of the Internal Revenue Code, *infra*. If

[2] The question whether the land was donated to the taxpayer was injected into the case by amendments to the Commissioner's answer in connection with his assertion that donated property was not properly includible in invested capital. Prior to the Tax Court's decision herein, this Court had held in *Brown Shoe Co.* v. *Commissioner*, 339 U. S. 583, that donated property was so includible.

[3] The Tax Court said: "The petitioner and the respondent seem to be in agreement that the property in question is to be included in petitioner's invested capital, if at all, at its fair market value when acquired by the petitioner" (R. 91).

acquired in exchange for stock, it is includible in invested capital at the fair market value of the stock issued therefor. Where the stock, as here, has no established market value at the time of the exchange, the fair market value of the stock is determined by the fair market value of the net assets of the corporation, including the market value of the property paid in for such stock. Treasury Regulations 112, Section 35.718–1, *infra*.[4] At the time the land was acquired, those assets consisted solely of cash on hand and the real estate in question (R. 130).[5]

2. The court below correctly upheld the Commissioner's reduction in invested capital by the amount of depreciation reserves withdrawn. Section 718 (b) (2), *infra*, p. 14, provides that for excess profits tax purposes the invested capital of a corporation shall be reduced by any distributions not from accumulated earnings and profits. The question whether a corporation has accumu-

[4] See *Hazeltine Corp.* v. *Commissioner*, 89 F. 2d 513, 518 (C. A. 3d); *Commissioner* v. *Schumacher Wall Bd. Corp.*, 93 F. 2d 79, 82 (C. A. 9th); *Champlin Refining Co.* v. *Commissioner*, 123 F. 2d 202, 203 (C. A. 10th); *Fahs* v. *Florida Machine & Foundry Co.*, 168 F. 2d 957, 958 (C. A. 5th); *Elrod Slug Casting Mach. Co.* v. *O'Malley*, 57 F. Supp. 915, 919 (D. Nebr.); *Dr. G. H. Tichenor Antiseptic Co.* v. *United States*, 77 F. Supp. 288, 292 (E. D. La.); 3 Mertens, *Law of Federal Income Taxation*, Sec. 21.16.

[5] Since the Tax Court found that the value of the land was substantially the same on January 6, 1913, and on March 11, 1913 (R. 91), it was unnecessary for it to determine on which date the land was acquired. (See R. 133–134.)

lated earnings or profits is largely a question of fact. The Tax Court here found that the taxpayer had no accumulated earnings and profits at the time the withdrawals in question were made (R. 94). That finding was clearly correct.

It is shown that taxpayer regularly distributed all of its earnings and profits by way of dividends (R. 94). That the withdrawals in question were from its depreciation reserve seems not to be in dispute (R. 93, Pet. 17–19). The Tax Court and the Court of Appeals held that depreciation reserves do not represent accumulated earnings and profits. This is in accord with consistent decisions of the courts, *e. g., Creamette Co.* v. *Commissioner,* 37 B. T. A. 216; *McKinney* v. *Commissioner,* 32 B. T. A. 450, affirmed, 87 F. 2d 811 (C. A. 10th); *Beretta* v. *Commissioner,* 1 T. C. 86, affirmed, 141 F. 2d 452 (C. A. 5th), certiorari denied, 323 U. S. 720. These decisions are based upon the truism, recognized both in accounting and in the revenue laws, that depreciation represents the wasting of a capital asset, and, therefore, must be deducted from gross income in order to determine earnings and profits.

CONCLUSION

The decision of the court below is correct, is not in conflict with any other decision, and presents no questions calling for review by this

Court. The petition for a writ of certiorari should be denied.

Respectfully submitted.

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NOVEMBER, 1951.

APPENDIX

INTERNAL REVENUE CODE

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * * *

(4) *Gift or transfer in trust before January 1, 1921.*—If the property was acquired by gift or transfer in trust on or before December 31, 1920, the basis shall be the fair market value of such property at the time of such acquisition.

* * * * *

(14) *Property acquired before March 1, 1913.*—In the case of property acquired before March 1, 1913, if the basis otherwise determined under this subsection, adjusted (for the period prior to March 1, 1913) as provided in subsection (b), is less than the fair market value of the property as of March 1, 1913, then the basis for determining gain shall be such fair market value. * * *

* * * * *

(26 U. S. C. 1946 ed., Sec. 113.)

SEC. 715 [as added by Sec. 201 of the SECOND REVENUE ACT of 1940, c. 757, 54 Stat. 974]. DEFINITION OF INVESTED CAPITAL.

For the purposes of this subchapter the invested capital for any taxable year shall be the

average invested capital for such year, determined under section 716, reduced by an amount computed under section 720 (relating to inadmissible assets). * * * (26 U. S. C. 1946 ed., Sec. 715.)

SEC. 716 [as added by Sec. 201 of the SECOND REVENUE ACT of 1940, *supra*]. AVERAGE INVESTED CAPITAL.

The average invested capital for any taxable year shall be the aggregate of the daily invested capital for each day of such taxable year, divided by the number of days in such taxable year. (26 U. S. C. 1946 ed., SEC. 716.)

SEC. 717 [as added by SEC. 201 of the SECOND REVENUE ACT of 1940, *supra*]. DAILY INVESTED CAPITAL.

The daily invested capital for any day of the taxable year shall be the sum of the equity invested capital for such day plus the borrowed invested capital for such day determined under section 719. (26 U. S. C. 1946 ed., SEC. 717.)

SEC. 718 [as added by SEC. 201 of the SECOND REVENUE ACT of 1940, *supra*]. EQUITY INVESTED CAPITAL.

(a) *Definition.*—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts, reduced as provided in subsection (b)—

(1) *Money paid in.*—Money previously paid in for stock, or as paid-in surplus, or as a contribution to capital;

(2) *Property paid in.*—Property (other than money) previously paid in (regardless of the time paid in) for stock, or as paid-in surplus, or as

a contribution to capital. Such property shall be included in an amount equal to its basis (unadjusted) for determining loss upon sale or exchange. * * *

* * * * *

(b) *Reduction in Equity Invested Capital.*—The amount by which the equity invested capital for any day shall be reduced as provided in subsection (a) shall be the sum of the following amounts—

(1) *Distributions in previous years.*—Distributions made prior to such taxable year which were not out of accumulated earnings and profits;

(2) *Distributions during the year.*—Distributions previously made during such taxable year which are not out of the earnings and profits of such taxable year;

* * * * *

(26 U. S. C. 1946 ed., Sec. 718.)

TREASURY REGULATIONS 112, PROMULGATED UNDER THE INTERNAL REVENUE CODE

SEC. 35.718–1. *Determination of Daily Equity Invested Capital—Money and Property Paid In.*—The equity invested capital for any day is determined as of the beginning of such day. The basis or starting point is found in the amount of money and property previously paid in for stock, or as paid-in surplus, or as a contribution to capital. The terms "money paid in" and "property paid in" do not include amounts received as premiums by an insurance company subject to taxation under section 204. For the purpose of determining equity invested capital,

the amount of any property paid in is the unadjusted basis to the taxpayer for determining loss upon a sale or exchange under the law applicable to the taxable year for which the invested capital is being computed. If the property was disposed of after February 28, 1913, and before such taxable year, such unadjusted basis shall be determined under the law applicable to the year of disposition, but without regard to the value of the property as of March 1, 1913; if the property was disposed of before March 1, 1913, its unadjusted basis shall be considered to be its fair market value at the time paid in.

If the basis to the taxpayer is cost and stock was issued for the property, the cost is the fair market value of such stock at the time of its issuance. If the stock had no established market value at the time of the exchange, the fair market value of the assets of the company at that time should be determined and the liabilities deducted. The resulting net worth will be deemed to represent the total value of the outstanding stock. In determining net worth for the purpose of fixing the fair market value of the stock at the time of the exchange, the property paid in for such stock shall be included in the assets at its fair market value at that time.

If stock having no established market value is issued for intangible property, and it is necessary to determine the fair market value of such property, the following factors, among others, may be taken into consideration in determining such value: (a) The earnings attributable to such intangible assets while in the hands of the predecessor owner; and (b) any cash offers for the

purchase of the business, including the intangible property, at or about the time of its acquisition. A corporation claiming a value for intangible property paid in for stock should file with its return a full statement of the facts relating to such valuation.

If the property was acquired after December 31, 1920, by a corporation from a shareholder as paid-in surplus or from any person as a contribution to capital, then the basis shall be the same as it would be in the hands of the transferor if the transfer had not been made. (See section 113 (a) (8).) If so acquired prior to January 1, 1921, the basis is the fair market value of the property at the time it was paid in. * * *

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